



FINANCE
ONE NORTH SAN ANTONIO ROAD
LOS ALTOS, CALIFORNIA 94022-3087

February 2, 2012

**Honorable Mayor and Members of the City Council
City of Los Altos, California**

We are pleased to present the Comprehensive Annual Financial Report (CAFR) of the City of Los Altos, California (the City) for the fiscal year ended June 30, 2011 with the Independent Auditors' Report. The CAFR was prepared by the City's Finance Department. The information contained in this CAFR is based on a comprehensive framework of internal control established for this purpose. The objective is to provide reasonable assurance that the financial statements are free of material misstatements. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the City. We believe that the data, as presented, are accurate in all material respects, that the presentation fairly shows the financial position and the results of the City's operations as measured by the financial activity of its various funds and that the included disclosures will provide the reader with an understanding of the City's financial affairs.

This letter of transmittal is designed to complement the Management's Discussion and Analysis (MDA) section of the CAFR and should be read in conjunction with it. The MDA provides a narrative introduction, overview and analysis of the Basic Financial Statements and can be found immediately following the report of the independent auditors.

PROFILE OF THE CITY AND ITS SERVICES

Tree-lined streets and a small village atmosphere characterize Los Altos, which is located in the heart of world famous Silicon Valley. Just 40 miles south of San Francisco, Los Altos is a residential community with a population of approximately 28,000 served by seven small retail areas. The seven square mile residential city is developed with small businesses, schools, libraries and churches. Incorporated on December 1, 1952, Los Altos is a general law city operating under the Council-Manager form of government. There are five Council members elected at large, serving four-year overlapping terms. Municipal services provided include police, street maintenance, engineering, community development, parks, recreation and sewer. Fire protection is contracted with the Santa Clara County Central Fire Protection District.

SERVICE EFFORTS AND MAJOR INITIATIVES

Service Efforts

In FY2010-2011, the City continued to provide a high level of service to its residents and citizens and adhered to its adopted financial plan as evidenced by the budget-to-actual reporting presented within this document. Budgetary limits were met with the General Fund reporting a healthy operating surplus again this year while fiscal safety reserves were strengthened as planned. All major funds performed as expected in line with cost mitigation efforts put in place in these times of economic recovery.

Major Initiatives

Capital Improvements: FY2010-2011 has marked another year of significant investments made in infrastructure improvements. Some key capital expenditures of note include the following:

\$ 1,865,000	Rosita Park & Right of Way
\$ 1,197,000	First Street Streetscape-Intersection Improvements
\$ 494,000	Annual Street Resurfacing
\$ 230,000	San Antonio Club Rehabilitation
\$ 219,000	Traffic Signal Controller & Cabinet Replacements
\$ 196,000	Municipal Service Center Fuel Station
\$ 177,000	Demolition of 400 Main Street
\$ 173,000	Blue Oak Lane Sewer
\$ 152,000	First Street Streetscape Design
\$ 132,000	Audible Pedestrian Signals
\$ 132,000	Fremont Avenue Bridge Design
\$ 126,000	Parkland Acquisition – Shoup & Redwood Grove Pathway
\$ 112,000	Annual Special Projects and Studies
\$ 98,000	Collector Traffic Calming Master Plan
\$ 82,000	San Antonio Road Streetscape Design
\$ 82,000	Annual Concrete Repairs
\$ 70,000	Parks Master Plan
\$ 67,000	Bicycle Transportation Plan Update

Downtown Revitalization: The City continued its focus on a series of capital projects intended to revitalize the core downtown district of Los Altos. These initiatives include San Antonio Road rehabilitation, the completion of undergrounding of utilities along First Street in the downtown area, the demolition of the 400 Main Street site, downtown intersection improvements and initiating the construction of transformative First Street improvements. Calendar year 2011 also conveyed significant progress made by the Packard Foundation nearing the completion of its state-of-the-art organizational headquarters and great progress made in solidifying an agreement with Safeway for the complete redesign and expansion of its downtown Los Altos store site. These endeavors continue to underscore the strategic posture the City has taken in addressing key foundational economic development matters.

Enhanced Open-Space: Nearly \$2 million in tax and development dollars were reinvested back into the community with the ground up redesign and reconstruction of Rosita Park and the adjacent community streetscape improvements. Rosita Park held its grand opening soon after FY2010-2011 in an improvement that has received acclaim from a cultural, environmental and neighborhood perspective. Completed on time and within budget this project further exemplifies the superior recreational park standards that establish Los Altos as a wonderful place to live and play.

The City also added to its open-space inventory this year with the purchase of land creating a natural bridge-way and connection point between Shoup Park and Redwood Grove. This land purchase marks the realization of a long time dream to link these two beautiful open spaces for the enjoyment of all. On a similar note, the City continues to partner with the community and environmental groups in restoring the natural habitat of Redwood Grove.

Nurturing of Roadways and Pedestrian Walkways: Significant dollars were put forth to further a variety of roadway, pedestrian and bikeway initiatives and improvements. Over \$1 million was expended on bridge improvements, street resurfacing and streetscape design projects, signal improvements and a bicycle transportation update. These efforts continue to maintain the City's high roadway condition index and developing alternative methods of transport.

Community Center Master Plan: The City continues its progress in furthering the Community Center Master Plan. Holding several workshops followed by extensive and inclusive civic engagement, the Master Plan was ultimately approved by Council in June 2009. The scope of the project involves the complete redevelopment of the civic center campus and several key service facilities including safety facilities, recreation facilities, community and senior centers, library services, athletic fields and community gathering points.

Beyond the Master Plan approval, the City is moving towards the completion of an updated city-wide survey to be completed in early 2012 as a basis for evaluating the feasibility of a city-wide bond election later in that year.

FINANCIAL CONTROLS AND PROCEDURES

Financial Policies: Throughout the years, the City has followed a fiscally conservative philosophy of building and maintaining healthy financial reserves. This practice has allowed the City to continue providing quality services to its residents in a time when many local agencies were being forced to cut back due to fiscal constraints. On an annual basis, the Council approves financial policies designed to promote sound financial management and ensure fiscal integrity over time. This CAFR reflects the implementation of these financial guidelines and presents all fund reserves and designations in an effort to define fund balance commitments and obligations as of the financial report date.

Internal Control Structure: City management is responsible for establishing and maintaining fiscal internal controls designed to safeguard the assets of the government from loss, theft or misuse and to ensure that accounting data is accurately compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of controls should not exceed the benefits likely to be derived and (2) the valuation of costs and benefits require estimates and judgments by management.

Cash Management Policies: In order to maximize investment leverage, it is the City's practice to "pool" available cash from all funds for investment purposes. In accordance with the annually adopted investment policy, available cash is invested with the goal of safety, meaning protection of principal, as the first priority, ensuring adequate liquidity as the second priority and maximizing yield as the third priority. This past year continued to display historic lows in interest rates with a drop in the Local Agency Investment Fund (LAIF) earnings rates below one half of 1%. This condition is expected to persist in the near term. Council and staff acted on their plan to engage investment advisory services and have started the process of diversifying its investment portfolio as a basis for mitigating the impact of interest rate swings. As always the emphasis remains on preserving the safety of principal.

Risk Management: The City is insured for general liability through the Association of Bay Area Governments (ABAG) that covers claims in an amount up to \$10 million with a deductible or uninsured liability of up to \$100,000 per claim. The City is self-insured for Workers' Compensation and has an excess insurance policy for such claims up to the statutory limits. The City has a \$1,000,000 deductible or self-insured liability. Effective July 1, 2010, the deductible for Workers' Compensation was lowered to \$250,000 to further enhance risk protection.

GASB 45 Compliance: This report complies with the provisions of Government Accounting Standard Board Statement No.45 (GASB 45). This recent standard pertains to Other Post Employee Benefits (OPEB) and requires the completion of an actuarial study to account for post employee benefit liabilities that exist. This new reporting requirement is described in financial note 11 of the CAFR and the related liabilities reflected in the statements. As of June 30, 2011, the City's net OPEB obligation was valued at \$604,000, an amount reflected in the government-wide statements. Long-term unfunded liabilities equal \$1.7 million. Over the past three budget cycles the City has earmarked and set aside \$300,000 in reserves to begin addressing this liability funding. Over the course of the next year, staff will evaluate the variety of funding options available to the City including, but not limited to, the establishment of a trust. In the interim, staff will account for these costs on a pay-as-you-go basis and build such charges into future budgets.

GASB 54 Compliance: This report marks the first and timely year of compliance with the provisions of Government Accounting Standard Board Statement No.54 (GASB 54). Council adopted an updated financial policy earlier this year reflective of this change, a significant one for the readers and users of our financial statements. The objective of this Statement is to enhance the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions. This Statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds.

EXECUTIVE FINANCIAL OVERVIEW

This executive financial overview is presented as a supplement to the more detailed and comprehensive analysis presented in the MDA. This section highlights key financial performance indicators for our major funds and we encourage all readers to review the MDA for a further analysis of the City's financial condition.

General Fund

The General Fund, the primary operating fund of the City, favorably exceeded expectations coming in with an operating surplus of \$2.3 million. We attribute this performance to our commitment to prudent financial planning, conservative budgeting and faithful departmental stewardship. At year end, the total General Fund balance equaled \$8 million with an unassigned fund balance of \$2.7 million after commitments and restriction of \$5.2 million. As planned for in budget process, some of this surplus has been allocated to increasing existing economic reserves and further funding OPEB with any additional remainder to be utilized at Council's discretion. The fiscal results herein bring the City closer to achieving its General Fund contingency reserve target of 20% having increased to a level of 18% with the close of FY2010-2011.

Considering the transfer and use of reserve activity listed below, most notably the use of \$1.5 million to fund future Capital Improvement Plan commitments, the final General Fund balance increased by \$830,000. This non-operating and transfer activity is as follows:

- \$1.5 million transfer out of operating surplus reserves to Capital Projects Fund
- \$165,000 transfer out for general debt service payments
- \$210,000 transfer in from the Gas Tax Fund for supporting engineering operations
- \$75,000 transfer in from public safety grant funds
- \$65,000 transfer out to subsidize storm drain operations
- \$22,000 transfer in from safety vehicle impound fees

The General Fund revenue stream appears to be slowly recovering from the recent recessionary economic trends, a condition that was much discussed and planned for in the recent and current budget cycle.

<i>Revenue (millions)</i>	<i>2011 Actual</i>	<i>2010 Actual</i>	<i>Variance \$</i>	<i>Variance %</i>
<i>Property Tax</i>	\$12.79	\$13.05	(\$0.26)	-2%
<i>Sales Tax</i>	2.59	2.26	0.33	15%
<i>Hotel Tax</i>	1.52	1.35	0.17	13%
<i>Utility Users Tax</i>	2.54	2.51	0.03	1%
<i>Other Taxes</i>	0.93	0.89	0.05	5%
<i>Franchise Fees</i>	1.81	1.44	0.38	26%
<i>Interest</i>	0.23	0.20	0.02	11%
<i>Recreation</i>	1.76	1.50	0.26	18%
<i>License and Permits</i>	2.56	2.53	0.03	1%
<i>Other</i>	1.92	2.04	(0.12)	-6%
Total	\$28.66	\$27.77	\$0.90	3%

General Fund revenues increased by 3% overall in contrast to a 2% increase in the prior year. Revenues came in at 103% of our annual budget estimates with Sales Tax, hotel tax, Franchise Fees and recreation services being the front runners. Property tax came in slightly lower for the first time in many years as the County projected an historic zero growth rate regionally. We are pleased to report relative stability, meeting budget projections, in this primary area of revenue generation that has experienced widespread assessment reductions in the greater region. Sales tax displayed a nice recovery coming off of the prior year double digit drop yet we remain in a retail climate that remains challenging and subject to a slow turnaround. Tourism has seen another uptick as indicated by the hotel tax increase of nearly 13% in contrast to a 5% gain last year. Interest income has stabilized although we should not expect strength in this area given the continued federal easing policies in place. Yield rates continue to fall to short term ranges well below 1%. Utility users tax and real estate transfer tax remained relatively stable while franchise fees performed well with the introduction of the newly crafted waste contract. License and permit fees were stable, a good sign given last year's strong performance. Recreation programs performed in an outstanding manner coming in 18% above last year revenue levels with enhanced programming and marketing.

General Fund expenditures came in 5% below budget contributing to the net surplus mentioned above. Compared to last year, expenses increased by \$1 million or 4% mostly driven by honoring previously approved labor agreements, employee benefits, utilities, maintenance, equipment and professional service costs. We continue to recognize that the City's revenue base remains delicate in this cycle of recovery and that rising costs in the areas of future pension rates, insurance and deferred maintenance costs remain a challenge. As such, we maintain our stance of maintaining prudent, proactive and conservative fiscal planning. These favorable results allow the City to move forward on its projected plans to further pay-down pension liabilities.

Other Funds

Capital Project Funds: The Capital Projects Fund was very active, with expenditure levels reaching \$6.1 million, ending the year with a total fund balance of \$9.2 million. As of June 30, 2011, \$2.2 million of this fund balance remains uncommitted to be applied to the funding of future projects as identified in the City's five-year capital plan. Our long-term forecasts again underscore the need to identify specific dedicated capital project funding sources as a means of eliminating this fund's reliance on General Fund residual transfers.

The Community Facility Renewal Fund, a fund designed to support city-wide facility improvements, had a fund balance of \$3.7 million at year end. Additionally, the Real Property Proceeds Fund ended the year with a fund balance of \$6.8 million having received an initial deposit on the conditional sale of property at 400 Main Street. Lastly, the Equipment Replacement Fund finished the year with a fund balance of \$3.9 million reflecting a use of funds this year.

Special Revenue, Internal and Enterprise Funds: All other Governmental and Business Type funds performed as expected. Non-major governmental funds ended the year with a combined balance of \$2.8 million while Enterprise funds ended the year with a combined balance of \$12.8 million.

Trust and Agency Funds: The City acts as a custodian of funds held for the benefit of others including the administration of the North County Library Authority. In a change made last year, the long-standing Raymundo and Avalon curb and gutter special assessment districts were reclassified to the trust and agency group in recognition of the limited nature of this debt which is fully collateralized by homeowner assessments without City obligation. The newly formed Blue Oak Lane Sewer district special assessment district is similarly treated.

ECONOMIC TRENDS

Although the City has performed relatively well this past year and maintained its target reserve levels, we exist in an economic climate and time replete with financial uncertainty and marked with historic nationwide and global challenges. As we navigate FY2011-2012 and beyond, we remain constantly aware of the financial threats that face all local municipalities. The existence of significant housing and credit pressures, the threat of the California State budget crisis, deepening national deficits and anemic retail activity prompt us to remain resourceful, effective and efficient as we develop our strategic and fiscal plans.

In 2011 the Government Accounting Standards Board (GASB) issued an exposure draft on pension accounting and financial reporting. Although not yet codified, the substance of this draft is expected to be adopted within the next two years. Its impact will be significant as it calls for government agencies to report and record the net pension liability in its financial statements above and beyond the current disclosure requirements. Wherein multi-employer pool based reporting was acceptable in the past, this new standard will require Los Altos to obtain an actuarial evaluation specific to its population characteristic as a basis to identify the City's specific pension benefit liability. In so far as the CALPERS pooled plan currently reflects an unfunded liability, we can assume to absorb our proportionate share of that amount.

INDEPENDENT AUDIT

The public accounting firm of Caporicci & Larson was selected to perform the annual independent audit. The auditors' report on the City's financial statements is included in the financial section of this report.

AWARDS

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the City for its CAFR for the fiscal year ended June 30, 2010. This was the sixth consecutive year that the City has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized CAFR. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current CAFR continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

ACKNOWLEDGMENTS

Preparation of this report could not have been accomplished without the efficient and dedicated services of the Finance Department staff. We would like to express our appreciation to all members of the department who contributed to the final product. We also want to thank Caporicci & Larson, our independent auditors, for their efforts in performing this year-end financial audit, as well as the Mayor, members of the City Council, and the City Manager for their leadership and support, without which the preparation of this report would not have been possible.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read 'R. Morreale', with a long, sweeping horizontal line extending to the right.

Russell J. Morreale
Finance Director